United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING

ORIGINAL

76-5028

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P/S

In The

United States Court of Appeals

For The Second Circuit

In re:

UNISHOPS, INC.,

Debtor.

JEROME ZELIN,

Appellant,

vs.

UNISHOPS, INC.,

Appellee.

On Appeal from the United States District Court for the Southern District of New York.

PETITION FOR REHEARING

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(10186)

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UNITED STATES COURT OF APPEALS

for the Second Circuit

Docket No. 76-5028

In re:

UNISHOPS, INC.,

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JEROME ZELIN,

Claimant-Appellant,

-against-

UNISHOPS, INC.,

Debtor-Appellee

PETITION FOR REHEARING

TO THE HONORABLE JUDGES OF THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT:

Preliminary Statement

Unishops, Inc. (hereinafter "Unishops"), the debtor-appellee above named, respectfully presents its petition for

rehearing in the above-entitled cause.

In an opinion by Circuit Judge Medina, joined in by Circuit Judges Anderson and Timbers, the court held: (a) that a certain executory contract remained in effect and therefore created a priority claim even though it was terminated by court order during the pendency of the Chapter XI arrangement proceeding; (b) that the debtor in possession received benefits under a pre-petition contract even though a local rule mandated a new employment approved by the court with compensation under the new employment fixed by order of the court; and (c) that an executive employment contract entered into prior to a Chapter XI proceeding and not terminated until the proceeding was under way would create an administrative damage claim entitled to priority treatment.

Appellee believes that the court overlooked the critical fact that the contract in question had been terminated by the debtor in possession during the proceeding (A19)* and that a formal rejection and disaffirmance of the contract pursuant to either §313(1) or §357(2) of the Bankruptcy Act, 11 U.S.C. §§713(1) and 757(2), would have been a meaningless act. Appellee further believes that the court misconceived the basis of the appellant's employment by the debtor in possession, and that the effects of the decision could be disastrous to the present and

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* See ¶13 of Agreed Statement of Facts (A19).

future administration of arrangement proceedings and bankruptcy cases in the context of aborted arrangement proceedings.

Statement of Facts

On March 19, 1973, Jerome Zelin ("Zelin") and Unishops entered into a letter agreement ("Letter Agreement") (A17). At that time, Zelin had been employed for some eleven years as the principal executive officer of Unishops, was a stockholder of the company and Vice Chairman of the Board of Directors (A17). The Letter Agreement was the only written agreement between the parties (A17) and spelled out provisions for Unishops to pay Zelin the sum of $100,000 over a two-year period in the event of the involuntary termination of his services (A10-A11).

On November 30, 1973, Unishops filed a petition for arrangement under Chapter XI of the Bankruptcy Act (A18) and became a debtor in possession (A18). Thereafter, on December 7, 1973, the Bankruptcy Court entered an order pursuant to Southern District Local Bankruptcy Rule XI-3 approving Zelin's employment by the debtor in possession and fixing his compensation at $100,000 per year, payable in monthly installments (A18). There was no reference in the order of December 7, 1973, or in the supporting application, to severance pay for Zelin or to the Letter Agreement. On or about July 16, 1974, during the course of the

arrangement proceedings, Unishops discharged Zelin (A19). On December 3, 1974, an order was entered by the Bankruptcy Court terminating the Letter Agreement effective July 16, 1974 (A19).

Zelin filed a claim in the arrangement proceeding asserting that he was entitled to payment of the $100,000 as a priority claim under §64(a)(1) of the Bankruptcy Act, 11 U.S.C. §104(a)(1), as an expense of administration of the debtor in possession (A8-A9). Unishops objected to the allowance of the claim as a priority claim asserting that it should only be entitled to the status of a general claim (A12-A 15).

The Opinion

The opinion deals with the application of the rule set out by Chief Judge Lombard in American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A., 280 F.2d 119, 124 (2d Cir. 1960), to the facts of this case. The rule is:

> "...The claim of a creditor having an executory contract with the debtor at the time the debtor's petition is filed is entitled to priority under these provisions [§64(a)(1) of the Bankruptcy Act, 11 U.S.C. §104(a)(1)] only if the trustee or debtor in possession elects to assume the contract or if he receives benefits under it...."

[See slip opinion at 3019.]

Judge Medina's opinion discusses both prongs of the rule. The direct holding of the opinion appears to be that "...the debtor [in possession] received benefits under the executory

contract..." [slip opinion at 3020); that "...the debtor in possession had received the benefit [of the Letter Agreement] by Zelin's continued service as executive officer after Unishops filed for Chapter XI..." [slip opinion at 3021]. The court also held that the Letter Agreement "...remained in effect..." [slip opinion at 3021] presumably because "...[n]o attempt was made by this debtor to disaffirm its executory contract with Zelin...." [slip opinion at 3019.]

I

An order was entered by the Bankruptcy Court on December 3, 1974, directing that the Letter Agreement be deemed terminated by Unishops on July 16, 1974 (A19). This undisputed fact was apparently overlooked by the court. The termination of the Letter Agreement was the equivalent of rejection of the Letter Agreement under §313(1) or §357(2) of the Bankruptcy Act, 11 U.S.C. §§713(1) and 757(2) . See In re Greenpoint Metallic Bed Co., 113 F.2d 881 (2d Cir. 1940). Certainly Unishops could have formally rejected the Letter Agreement subsequent to entry of the December 3, 1974, termination order and up until the date the arrangement proceeding was confirmed, but this would have been like carrying coals to Newcastle -- a meaningless act.

Section 63(c) of the Bankruptcy Act, 11 U.S.C. §103(c) declares that the rejection of an executory contract "...shall constitute a breach of such contract...as of the date of the

filing of the petition initiating a proceeding under this Act." The court-approved termination has the same effect, In re Greenpoint Metallic Bed Co., supra, with the same result, i.e., a general claim for breach of contract. Seedman v. Friedman, 132 F.2d 290 (2d Cir. 1942).

In In re Miracle Mart, Inc., 396 F.2d 62, 65 (2d Cir. 1968), this court discussed the issue of priority status for a claim under a rejected executory contract:

> "We have also considered appellants' argument that at least claims for damages as to some of the leases, which were breached by the closing of some of the debtor's stores during the arrangement proceeding, are entitled to priority status. However, 'breach' in fact of an executory contract by the debtor during the period of administration does not necessarily make the damages that flow therefrom costs of administration. See Greenpoint Metallic Bed Co., supra. The leases were executory when the petition for an arrangement was filed, and the 'breach' was followed by court-approved rejection. Under these circumstances, administration status was not justified."

The Zelin Letter Agreement was similarly breached by the debtor during the arrangement proceeding by Zelin's discharge and by the order of December 3, 1974 (A19).

Giving due weight to the court-approved termination of the Letter Agreement (which is tantamount to rejection of the Letter Agreement), it becomes apparent that the debtor in possession did not assume the Letter Agreement. The next question

is whether the debtor in possession received any benefit under the Letter Agreement.

II

There is a sharp, real distinction between benefit derived from an officer's employment and benefit derived from a pre-petition agreement dealing with the officer's employment. This court has repeatedly held that a debtor in possession is a new entity distinct from the debtor. Shopmen's Local Union No. 455 v. Kevin Steel Products, Inc., 519 F.2d 698, 704 (2d Cir. 1975); Brotherhood of Railway, Airline and Steam Clerks, Freight Handlers, Express and Station Employees, AFL-CIO v. REA Express, Inc., 523 F.2d 164, 170 (2d Cir. 1975), cert. den. 423 U.S. 1017, 1073 (1975. 1976); Allegaert v. Perot, 548 F.2d 432, 436 (2d Cir. 1977).

As a new juridical entity, a debtor in possession is not bound by the debtor's executory contracts "...unless and until the contract should be assumed, either expressly or [by] conforming to its terms without disaffirmance...." Brotherood of Railway, etc., v. REA Express, Inc., supra, 523 F.2d at 170*. As previously indicated, the Letter Agreement was terminated by the debtor in possession. Furthermore, the debtor in possession did not conform to the terms of the agreement because the only "employer" obligation thereunder was payment of severance, which was not done.

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* In the REA case, the court held that the debtor in possession was a "new employer" within the meaning of the Railway Labor Act, 45 U.S.C. §151 et seq.

As a new employer, the debtor in possession entered into a new contract of employment with Zelin. By local court rule*, this contract had to be approved by court order which also fixes the officer's compensation. It should be apparent that the benefit received by the debtor in possession by Zelin's continued employment emanated from the new contract and had nothing to do with the Letter Agreement. The debtor in possession paid for this benefit pursuant to the terms of the order dated December 7, 1973, at a rate of $100,000 per year. There was no benefit derived by the debtor in possession from the Letter Agreement.

III

The rationale of the court's opinion has far-reaching adverse implications for other proceedings under the Bankruptcy Act. Many companies filing petitions for arrangement under Chapter XI of the Bankruptcy Act have employment agreements with officers and other personnel for stated terms, and sometimes with explicit severance pay provisions. As a practical matter, a debtor in possession must continue, at least initially, the employment of key executive, administrative personnel. During the course of the reorganization process, the debtor in possession will often reduce this staff, thereby terminating the employment of a number of officers and employees under contract. The debtor can then terminate and reject the contracts pursuant to §313(1)

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* See slip opinion at 3020, n.2

of the Bankruptcy Act, 11 U.S.C. §713(1) , or as part of the plan of arrangement pursuant to §357(2) of the Bankruptcy Act, 11 U.S.C. §757(2) . There is no time limitation within which such action must be taken as there is under §70b of the Bankruptcy Act, 11 U.S.C. §110b , wherein a trustee must assume contracts within sixty days or they are deemed rejected. However, under the rationale of Judge Medina's opinion, the officer's continued employment would have benefited the estate, thus giving rise to a priority administration claim.

Thus, Judge Medina's opinion creates a frightening spectre for the future debtor in possession. Must he now terminate all officers and employees at the eve of his filing and then clearly and explicitly rehire them as a debtor in possession under new terms and conditions? Can a debtor in possession afford to terminate an officer or employee during the course of the reorganization process knowing that such termination will give rise to a large priority administration claim?

A second dimension of this problem can be seen in those situations where an arrangement proceeding under Chapter XI of the Bankruptcy Act is unsuccessful, aborts, and ends up as a liquidation proceeding. At this point or shortly thereafter, all officers and employees will have their employment terminated. Their employment has given benefit to the debtor in possession. Are their claims for breach of their employment contracts administration claims of the debtor in possession?

In essence, appellee believes that the rationale of Judge Medina's opinion concerning the "benefit" concept creates untold havoc in existing arrangement and bankruptcy proceedings and creates unnecessary obstacles for future cases. It conflicts with the intent of §§63(c), 70(b), 313(1) and 357(2), 11 U.S.C. §§103(c), 110(b), 713(1) and 757(2), which is to render damage claims under terminated executory contracts into general claims. The rationale is wrong and appellee's motion for a rehearing should be granted and the district court's opinion should be affirmed.

Respectfully submitted,

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A 202 Affidavit of Personal Service of Papers — LUTZ APPELLATE PRINTERS, INC.

COURT OF APPEALS-SECOND CIRCUIT

In re: UNISHOPS, INC.,
Debtor.

JEROME ZELIN,
Appellant,
- against -
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Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF New York *ss.:*

I, Kevin E. Thomas, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at 1515 Macombs Road, Bronx, N.Y. 10452,
That on the 17th *day of* May *19* 77 *at* 655 Third Ave. N.Y. N.Y.

deponent served the annexed Petition for Rehearing *upon* Natanson, Reich & Barrison

the appellant *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the* attorneys *herein,*

Sworn to before me, this 17th *day of* may *19* 77

Kevin E Thomas
Print name beneath signature
KEVIN E. THOMAS

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31 0418950
Qualified in New York County
Commission Expires March 30, 1979